Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended	)))))	CC Docket No. 96-149

REPLY COMMENTS OF MCI TELECOMMUNICATIONS CORPORATION
CONCERNING EXPEDITED RECONSIDERATION OF SECTION 272(e)(4)

MCI Telecommunications Corporation (MCI), by its undersigned attorneys, hereby replies to the Bell Operating Companies' (BOCs') comments submitted in response to the April 3rd Public Notice in this docket concerning the issue remanded by the Court's Order in the *Bell Atlantic* case.[1] In that Order, the Court granted the Commission's motion for a voluntary remand of the issue of the proper interpretation of Section 272(e)(4) of the Communications Act of 1934, added by the Telecommunications Act of 1996 (1996 Act). As MCI argued in the *Bell Atlantic* case and as explained in its initial comments in response to the Public Notice (MCI Remand Comments), the Commission's reading of Section 272(e)(4) in its First Report and Order and Further Notice of Proposed Rulemaking in this proceeding (Order)[2] not only is permitted by its language, but is also the only conceivable interpretation of that provision in light of the structure and intent of the 1996 Act.

In their comments, the BOCs largely elaborate on the themes they previously set out in their earlier comments and in their

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[1] Bell Atlantic Telephone Companies, et al. v. FCC, No. 97-1067 (D.C. Cir. Mar. 31, 1997).

[2] FCC 96-489 (released Dec. 24, 1996).

motion papers in *Bell Atlantic*. They repeat their claims that Section 272(e)(4) is a stand-alone grant of authority to the BOCs to provide interLATA facilities and services to their separate affiliates free of any of the restrictions in Sections 271 and 272(a) and (b). They also argue that whereas Section 272(a) requires the BOCs to offer certain interLATA services only "through" a separate affiliate, Section 272(e)(4) specifies the conditions for BOC provision of interLATA services or facilities to the affiliate. Section 272(e)(4) thus demonstrates, according to the BOCs, that such provision does not violate Section 272(a). They also repeat their insistence that the "[o]rigination of interLATA telecommunications services" in Section 272(a)(2)(B) refers only to retail services to end users and that the provision of interLATA facilities and services to a separate affiliate therefore does not constitute such origination of service.[3]

US West, in its separate filing, suggests a variation under which the "interLATA telecommunications services" that only a separate affiliate may provide under Section 272(a)(2)(B) refer to a subset of "interLATA services" under Section 271(b)(1).[4]

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[3] Bell Company Comments at 2-5.

[4] Another party, Omnipoint Communications Inc., presents still a third variation, under which a BOC's provision of high capacity circuits to another carrier does not constitute the provision of "telecommunications services," but would be the provision of "interLATA ... facilities" under Section 272(e)(4). Omnipoint also does not view the wholesale/retail dichotomy as useful here. Omnipoint Comments at 2, 7-10 & n.15. Such a "facilities/services" dichotomy, however, would fly in the face of the Commission's long-standing treatment of the provision of

Under this approach, Section 272(e)(4) establishes that a BOC's provision of interLATA services and facilities to its affiliate does not constitute the provision of interLATA telecommunications services. US West also has a different spin on the term "origination" in Section 272(a)(2)(B), which it views as referring to origination versus termination of a call, rather than a retail/wholesale dichotomy.[5]

The BOCs also challenge MCI's point that their interpretation would render superfluous the authorization of joint marketing in Section 272(g)(2) by arguing that authorization to provide interLATA services to a separate affiliate would not include the marketing of services on behalf of the affiliate. Finally, they challenge the contention that their interpretation undermines the separation requirements, arguing that those requirements make all transactions between a BOC and its affiliate transparent and place the affiliate on equal terms with all of its competitors.[6]

MCI has already addressed the BOCs' main statutory construction arguments in its initial Remand Comments. As MCI pointed out, the Commission has the stronger hand at this juncture, since the *Bell Atlantic* Court went out of its way to deny the Bell Atlantic/Pacific Bell Motion for Summary Reversal

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facilities as similar to the provision of services. See MCI Remand Comments at 15-17.

[5] US West Comments at 1-5.

[6] Bell Company Comments at 6-9.

before granting the Commission's Motion for Voluntary Remand. Thus, the Court did not find the meaning of Section 272(e)(4) so "plain" that it could reject the Commission's interpretation. Indeed, the BOCs concede that one of the cases they cite holds that "any" only "generally" means "all" or "every."[7] The Commission must therefore resort to the tools of statutory construction applicable to ambiguous language.

The BOCs argue that there is no conflict between Section 272(e)(4) and the restrictions in Sections 271 and 272(a) and (b), since Section 272(a) states that a BOC may only provide certain interLATA services "through" its affiliate. The BOCs never precisely explain the significance of the word "through" in that context, or the significance of the distinction between that word in Section 272(a) and the provision of services and facilities "to" the affiliate in Section 272(e)(4). The entire discussion begs the question, since it is not clear from the language of these provisions why wholesale interLATA service does not have to be provided "through" the affiliate to the same extent as retail service. Section 272(e)(4) would then still be confined to the BOC's provision "to" the affiliate of those categories of interLATA services and facilities that the BOC could provide directly, rather than through an affiliate.

MCI has pointed out that under the BOCs' interpretation of "origination" as a retail-only concept in Section 272(a)(2)(B), the same approach to the term "originating" in Section 271(b)(1)

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[7] Id. at 7 n.5.

would prevent the BOCs and their interLATA affiliates from ever being allowed to provide interLATA service to any other carrier.[8] The BOCs, no doubt anticipating such an argument, attempt to deal with it by suggesting that "originating" in Section 271(b)(1) is used to identify the location where interLATA services begin, whereas "origination" in Section 272(a)(2) refers to the "specific activity of providing interLATA services to the customers who initiate interLATA calls."[9] This distinction does nothing for the BOCs' argument, however, since both wholesale carriers and resellers "provid[e] ... services to the customers who initiate interLATA calls." In both Section 271(b)(1) and 272(a)(2)(B), "origination" and "originating" refer to the services that enable a customer to initiate an interLATA call; there are no retail service connotations to those terms.

US West's approach is equally defective, since the difference between "interLATA services" and "interLATA telecommunications services" is that the former includes information services, which are not telecommunications services.[10] US West refuses to explain its view of what the difference is between interLATA services and interLATA

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[8] MCI Remand Comments at 13-14. MCI incorrectly referred twice to "Section 272(b)(1)" on page 14 instead of "Section 271(b)(1)" in making this point. Counsel regrets any confusion that may have been caused by this error.

[9] Bell Company Comments at 5 n.3. Bell counsel apparently have the same problem as MCI counsel, referring to "section 271(a)" in the first line of footnote 3 instead of Section 272(a).

[10] See Order at ¶¶ 55-57.

telecommunications services, and thus there is no basis to evaluate its claim that there are some "interLATA services that are not also interLATA telecommunications services" that BOCs may provide directly.[11]

The BOCs can fare no better with their argument that the specific authorization in Section 272(e)(4) overrides the general restriction in Section 272(a). They do not dispute that, as MCI explained in its Remand Comments, a BOC's separate affiliate could become a shell under their interpretation, while the BOC built, operated and maintained the affiliate's entire network. An exception that swallowed the general rule of separate provision of in-region interLATA services could not be considered "specific." The fact that Section 272(e)(4) uses the word "may" hardly provides the license the BOCs seek to eviscerate the separation requirements, since any permissively worded rule is limited by its context. Moreover, since the restrictions on a BOC's authority to provide interLATA services directly are established in Sections 271 and 272(a) and (b), there was no need to repeat them in Section 272(e)(4) itself. That provision must be read in light of the restrictions in the other provisions.

The BOCs fail to deal with MCI's Section 272(g) argument. If BOCs were permitted to provide and operate their affiliates' facilities and essentially do all of the work necessary for the provision of interLATA services, they would also be performing marketing services for the affiliate. Moreover, that marketing

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[11] US West Comments at 5-6.

itself is not an "interLATA service" makes no difference; it certainly is an element of the provision of such service. Thus, the provision of marketing services to an affiliate would be subsumed within the provision of interLATA services allowed by Section 272(e)(4), if that section were given the BOCs' open-ended interpretation.

The BOCs' oath of fealty to the separation requirements in Section 272 is ludicrous. It is precisely those requirements that would be eviscerated by the scheme they propose. They mention the arm's-length transaction requirement of Section 272(b)(5), but that would be rendered irrelevant by the takeover of the affiliate's interLATA operations by the BOC permitted under the BOCs' reading of Section 272(e)(4). All that would be left of the affiliate would be a hollow corporate shell housing a stack of "arm's-length" contracts for facilities and services provided by the BOC. Of course, the BOCs do not mention the most important separation requirement of all -- namely, the independent operation requirement of Section 272(b)(1). Since the BOC would be able to do everything for the affiliate under the BOCs' approach, independent operation would be logically impossible.

The BOCs argue that, because of the Section 272 separation and nondiscrimination requirements, there would be no incentive to cross-subsidize their interLATA facilities and services, since the latter have to be offered to competitors at the same rates and on the same terms as they are offered to the affiliates. As

pointed out in the attached Declaration of A. Daniel Kelley, however, the BOCs could design and provision interLATA facilities and services tailored to the unique needs of their affiliates.[12] Such facilities and services could ostensibly be made available to all entities on an equal basis, but would not provide the same value to others as to the affiliate, resulting in a subsidization of the affiliate by the BOC. Moreover, even if the BOC were to subsidize the interLATA facilities and services that it made available to and were used by competitors of its affiliate, such subsidization would tend toward a monopolization by the BOC of the wholesale provision of interLATA services, eventually resulting in reduced retail interLATA competition.[13]

The BOCs give short shrift to the Commission's questions in the Public Notice, preferring to devote their attention to the supposed economic benefits of their interpretation of Section 272(e)(4).[14] As explained in the Kelley Declaration, however, the BOCs' interpretation will not produce such benefits and in fact will be harmful to interLATA competition -- which is now extremely vigorous and continues to generate enormous benefits to consumers -- by facilitating cross-subsidization and discrimination.

One point that should be emphasized here is that BOC

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[12] Declaration of A. Daniel Kelley, attached as Exhibit A, at ¶ 18.

[13] Id. at ¶¶ 18-19.

[14] Bell Company Comments at 10-13 and attached affidavits.

provision of in-region interLATA facilities and services to their affiliates cannot be justified on the grounds that BOCs are already permitted to provide bottleneck access services to their affiliates, with no resulting harm.[15] First, the greater level of competition in interLATA services would equally justify BOC provision of retail in-region interLATA services, which all parties concede is prohibited. Second, the BOCs have a monopoly over some of the facilities that would be offered for interLATA purposes.[16] Third, the BOC affiliates may well need to obtain access services from the BOCs in some situations in order to provide interLATA services. BOC provision of access services to their affiliates and all others is therefore justified by economic and statutory policy reasons that do not apply to BOC provision of in-region interLATA facilities and services.

Finally, the BOCs have completely stonewalled the Commission in its efforts to learn what their plans are for their official services networks or how they will be able to use facilities for both intraLATA and interLATA purposes.[17] They also do not explain why they have been building interLATA networks apparently incorporating parts of their existing interLATA official services networks before they obtain in-region authority and without offering unaffiliated IXCs any opportunity to secure the use of

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[15] See id. at 11.

[16] Kelley Declaration at ¶¶ 17-19.

[17] See Bell Company Comments at 13 n.8; US West Comments at 9.

such networks on a nondiscriminatory basis. They also fail to explain why they expect to have excess switching capacity (so local switches can handle interLATA calls) or why the network staff has the spare time to design and operate the interLATA network.[18] All of these gaps in the BOCs' comments should raise a red flag for the Commission that acceptance of their interpretation of Section 272(e)(4) would lead to massive cross subsidies and discrimination, to the detriment of the interLATA competition that the 1996 Act was intended to foster.

Accordingly, the language, structure and purpose of Section 272(e)(4) and of the 1996 Act overall require that Section 272(e)(4) be construed to permit the BOCs to provide to their affiliates only those interLATA facilities and services that they are otherwise permitted to provide directly by Sections 271 and 272(a).

Respectfully submitted,

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Dated: April 24, 1997

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[18] See Moebius Declaration attached to Bell Company Comments at ¶¶ 5-6; MCI Remand Comments at 11-12.

Exhibit A

DECLARATION OF A. DANIEL KELLEY

1. I have been asked by MCI Telecommunications Corporation to respond to economic issues raised in the April 16, 1997 Affidavit of William E. Taylor in CC Docket No. 96-149, Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act, As Amended.

I. QUALIFICATIONS

2. I have been employed by Hatfield Associates, Inc. of Boulder, Colorado for the past seven years. My title is Senior Vice President. At Hatfield Associates I have conducted economic and policy studies for a variety of telecommunications industry and government clients. In recent years I have investigated local telephone company economic costs, analyzed competitive issues in local telecommunications markets, and studied privatization and deregulation initiatives in a number of Central European and Latin American countries.

3. My professional experience began in 1972 at the Antitrust Division of the U.S. Department of Justice where I conducted economic analysis of mergers, acquisitions and business practices in a number of industries, including telecommunications. While at the Department of Justice, I was a member of the economic staff of U.S. v. AT&T. In 1979, I moved to the Federal Communications Commission ("FCC") where I held positions as Senior Economist in the Common Carrier Bureau and the Office of Plans and Policy, and also served as Special Assistant to the Chairman. After leaving the FCC, I was a Project Manager and Senior Economist at ICF, Incorporated, a public policy consulting firm. From September 1984 through July of 1990, I was employed by MCI Communications Corporation as its Director of Regulatory Policy. At MCI, I was responsible for developing and implementing MCI's public policy positions.

4. I received a Bachelor of Arts degree in Economics from the University of Colorado in 1969, a Master of Arts degree in Economics from the University of Oregon in 1971 and a Ph.D. in Economics from the University of Oregon in 1976. I have published research in antitrust and telecommunications economics.

5. I have testified on telecommunications issues before the Colorado, Florida, Georgia, Hawaii, Maryland, Massachusetts, Michigan, New Jersey, New York, Oregon, and Pennsylvania Commissions, as well as this Commission and the State-Federal Joint Board that is currently investigating universal service reform. I have provided Affidavits or Declarations on telecommunications competition issues to the U.S. Department of Justice and the U.S. District Court in U.S. v. Western Electric. A copy of my resume is attached.

II. DR. TAYLOR'S CONCLUSIONS ARE INCORRECT

6. Dr. Taylor concludes "that there is no economic reason to restrict the supply of interLATA services by a BOC to its interLATA affiliate beyond the nondiscrimination requirements of the Act and in fact such restrictions would be harmful." [para. 3] He bases this conclusion on four specific findings. His first specific finding is that integrated provision of local and long distance services by BOCs would benefit consumers. The second finding is that the supply of interLATA services to BOC affiliates is not anticompetitive because the Telecommunications Act of 1996 ("1996 Act") already allows BOC provision of access services to its affiliates. The third finding is that BOC provision of services to downstream affiliates or divisions in enhanced services, customer premises equipment, and cellular markets demonstrates that competition will not be harmed if BOCs are allowed to supply interLATA services to affiliates. Finally, Dr., Taylor finds that as long as competitors can acquire access from BOCs on

the same terms and conditions as the BOC affiliates, competition in the interLATA market will not be harmed, even if access and interLATA facilities are bundled.

7. Dr. Taylor's conclusion is incorrect. The costs of allowing the BOCs to provide interLATA services to their affiliates are likely to exceed the benefits, if any. The interLATA market is already competitive. The 1996 Act creates a framework that allows any alleged economies of integration between local and long distance services to be captured for the benefit of consumers by the existing providers of interLATA services. The fact that exchange access is being supplied under monopoly conditions is not, as Dr. Taylor claims, a basis for allowing the BOCs to provide interLATA services as well. The joint supply of competitive interLATA services and monopoly access services will cause competitive problems. The examples that Dr. Taylor advances for the proposition that it is safe to allow BOCs to provide competitive and monopoly services without the benefit of separate subsidiary safeguards either show the opposite, or are inapposite. Finally, the nondiscrimination safeguard is insufficient to prevent monopoly abuse by the BOCs in the interLATA market, whether or not access and interLATA services are bundled. If the discrimination safeguards had worked in the past, antitrust cases would not have been filed, divestiture would not have been necessary, and the 1996 Act would not have included the substantial additional safeguards contained in Section 272.

III. THE INTERLATA MARKET IS COMPETITIVE

8. The interLATA market is competitive. Thus the only possible consumer benefit from BOC supply of interLATA services to interLATA affiliates would be through realizing economies of vertical integration. Given competitive interLATA markets, and absent economies, consumers would at best be indifferent to BOC provision of interLATA services. At worst they would be

harmed by the potential for cross-subsidy and discrimination. Since the BOCs and Dr. Taylor have argued that interLATA markets do not perform competitively, it is useful to review the evidence.[1]

9. Barriers to entry into the long distance market are low. There are literally hundreds of competitors in the interLATA market, including four with nationwide networks. New firms have entered and are competing aggressively using a variety of technology and marketing strategies. New entrants do not have to construct their own networks. They can rely on a fully-functioning wholesale capacity market.[2] Nevertheless, substantial new capacity is being constructed.[3]

10. The firms in the interLATA market aggressively compete for customers by offering discount plans that have become increasingly generous. Contrary to assertions made by Dr., Taylor in the past, long distance carriers have flowed the benefits of access charge reductions through to consumers.[4] As the Commission Staff recently demonstrated, over the period 1992

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[1] Dr. Taylor has in the past claimed that the interLATA market is not competitive. See William E. Taylor and Douglas Zona, "An Analysis of the State of Competition in Long Markets," National Economic Research Associates (May 1995).

[2] The BOCs themselves have taken advantage of this market to acquire capacity for out of region services.

[3] See IXC Communications, Prospectus (March 11, 1997).

[4] That access reductions have been flowed through in the past is sufficient to demonstrate competitive behavior by IXCs, but not necessary. Access is a substantial portion of the total expenses of long distance carriers, but there are other significant expenses as well. Competitive firms base prices on their economic costs. If reduced costs for some inputs are balanced by increased costs for others, no price reduction would be forthcoming. Note, however, that in this competitive market, consumers are better off than they would have been had there not been some cost reductions.

through 1995, "declines in access cost per minute account for about half of the declines in toll rates."[5] In other words, toll rates fell faster than did access charges.

11. The development of long distance competition is one of the outstanding successes of antitrust and regulatory policy in this country in any era. In my view, this Commission's implementation of the 1996 Act will be judged a great success if local markets become as competitive in the next twelve years as the long distance market has become in the time since divestiture. In this environment, the only possible benefit of BOC entry would the result of economies of vertical integration that are not otherwise available through alternative market mechanisms.[6]

IV. ECONOMIES OF VERTICAL INTEGRATION ARE UNLIKELY

12. Dr. Taylor claims that "to economists, rules that restrict transactions between firms or between organizations within a firm are costly to consumers, in that they necessarily raise the cost of supplying the final goods or services." [para. 5, emphasis supplied] This statement is too strong. The proof that it is incorrect is simple: if it were correct, there would be only one firm in the economy. In fact, diseconomies of integration limit the size and scope of firms.

13. It must also be recognized that markets allow efficiencies to be captured without the need for vertical integration. Existing interLATA competitors are very efficient. They have acquired the technical expertise and facilities they need through efficiently functioning labor and equipment

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[5] See Jim Lande, "Telecommunications Industry Revenue: TRS Fund Worksheet Data," December 1996, p. 9.

[6] See Robert E. Hall and Victoria A. Lazear, "The Optimal Pattern of Competition in the Telephone Industry," Applied Economic Partners (December 1994), for a more extensive discussion of long distance market competition.

markets. Any claim that the affiliate must rely on expertise found only in the BOC must be viewed with skepticism. It is more likely the case that the advantage of relying on the BOC for facilities or expertise is simply that local monopoly ratepayers are providing subsidies.

14. Even if it were true that there are vertical economies associated with the provision of interLATA services by a BOC that cannot be captured through efficient input markets, it does not necessarily follow that integration should be allowed. The risk of discrimination and cross-subsidy must be weighed against any benefits of integration. Moreover, if the benefits of competitive supply at the final goods stage exceed the costs of monopoly supply when there are economies of integration, then consumers are better off with the restriction.

15. In any event, integration is not necessary to generate economies of density, connectivity and scale, as the Commission has found:

> The incumbent LECs have economies of density, connectivity, and scale; traditionally, these have been viewed as creating a natural monopoly. As we pointed out in our NPRM, the local competition provisions of the Act require that these economies be shared with entrants. We believe they should be shared in a way that permits the incumbent LECs to maintain operating efficiency to further fair competition, and to enable the entrants to share the economic benefits of that efficiency in the form of cost-based prices.[7]

In other words, economies can be shared by requiring the unbundling of network elements and pricing them at cost. Given such unbundling, which is made technically feasible by the increased modularization of network components, the economies that Taylor hypothesizes will be available to all consumers, whether or not the BOCs are vertically integrated into interLATA services. Once transport and switching functions are unbundled and made available to all competitors at

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[7] See Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499 (1996) ("*Local Competition Order*"), para. 11.

economic cost, there is no reason why interLATA facilities need to be placed within the BOC in order to allow consumers to receive any benefits from economies. Access charge reform will also obviously allow all interLATA carriers to make efficient use of the intraLATA networks.

16. BOCs already own interLATA facilities. As described in the Affidavit of Mr. Moebius, they would like to use these facilities in the provision of interLATA services. [para. 3] One possible solution is to transfer the interLATA facilities to the Affiliate at a market-based price. Then, if the intraLATA operations of the BOC require interLATA services, they can be purchased at competitive rates from long distance carriers. However, this solution is problematic. It must be recognized that there are serious cross-subsidy problems with such a transfer. Ratepayers have already paid for a portion of the cost of these facilities, which may have been constructed or over-built in contemplation of interLATA entry. Therefore, establishing a market price for the transfer of these facilities will be difficult. Even an auction of the facilities may fail to reveal the appropriate transfer price because the BOC affiliate would be uniquely situated to take full advantage of the existing facilities.

V. BOCS HAVE THE INCENTIVE AND ABILITY TO BEHAVE ANTICOMPETITIVELY IN THE SUPPLY OF INTERLATA SERVICES TO AFFILIATES

17. Dr. Taylor believes that BOCs will not behave anticompetitively in the supply of interLATA services to affiliates. He bases this conjecture on two propositions. The first is that because the BOCs do not supply interLATA services today, they have no market power to leverage into the retail interLATA market. [para. 5] The problem, however, is that the BOCs do have market power in services provided over the same facilities that would be used to provide interLATA services to their affiliates. There are myriad ways in which their control over facilities

used for both inter and intraLATA services could be used to disadvantage their downstream interLATA competitors.

18. Cross-subsidization of interLATA facilities will be particularly easy if they are provisioned jointly with intraLATA facilities. Economic efficiency will be reduced because interLATA facilities will be underpriced and intraLATA facilities overpriced. Technical discrimination will also be possible. With changing technology, the BOCs could design and provision interLATA services designed to take unique advantage of the evolving capabilities of the local network.[8] Competition would be reduced at the wholesale level, and ultimately at the retail level as well. In sum, the risks of allowing the BOC to provide wholesale services to the affiliate are just as great as the risk of allowing the BOC to provide retail services.

19. The second proposition used by Dr. Taylor to argue that BOCs will not behave anticompetitively is that since the BOC is permitted to supply its affiliate access services over which there is a current monopoly, then provision of interLATA services for which no current monopoly exists should be permitted. [para. 6] As I noted above, the BOCs do in fact have a monopoly over some of the facilities that will be used to provide interLATA services to their Affiliates. Switches and transmission facilities currently used to provide the BOCs' intraLATA services will be used to provide interLATA services to the affiliate if the separate subsidiary safeguard is not applied. The point of the separate subsidiary safeguard is that with separate facilities and personnel, cross-subsidization and cost misallocation is made more difficult and discrimination becomes easier to detect. If BOCs are allowed to provide their affiliates with

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[8] See B. Douglas Bernheim and Robert D. Willig, The Scope of Competition in Telecommunications (October, 1996), Chapter 4.

interLATA services, the effectiveness of this safeguard will be substantially reduced. While there is no guarantee that cross-subsidization and discrimination will be prevented, Congress in the 1996 Act evidently made the judgement that the risk is sufficiently reduced when a separate subsidiary and the other safeguards contained in the 1996 Act are required.

VI. ACTUAL MARKET EXPERIENCE DOES NOT ELIMINATE CONCERN THAT BOCS WILL HARM COMPETITION

20. Dr. Taylor cites BOC vertical integration into corridor and intraLATA long distance service, cellular, voice messaging (VMS) and customer premises equipment, as evidence that existing safeguards will work if the BOCs are allowed to provide interLATA services to their affiliates. [para. 12] Dr. Taylor also cites the presence of non-BOC local telephone companies in interLATA markets.

21. Neither corridor nor intraLATA toll services provide an adequate test of the proposition that discrimination will not occur. In the case of corridor traffic, the ability of the BOC to do significant damage is limited because customers typically must dial around their presubscribed interLATA carrier in order to use the BOC for corridor calls. Cross-subsidy and discrimination are unlikely to overcome this large burden. In the case of intraLATA toll, BOCs have retained monopoly power precisely because they have engaged in significant discrimination. In particular, the BOCs refused to provide intraLATA equal access until ordered and then delayed its implementation. For example, Ameritech repeatedly challenged state commission orders to provide intraLATA one-plus presubscription, resulting in a serious delay of intraLATA toll competition. For almost ten years, US West successfully resisted orders from the Minnesota regulator to provide one-plus intraLATA dialing.

22. The problems do not stop once intraLATA equal access is ordered. The Kentucky and Florida Public Service Commissions found that BellSouth engaged in anticompetitive business office practices to disadvantage its intraLATA rivals.[9] Ameritech initiated "PIC freezes" in three of its five states, just when those intraLATA markets were opened to presubscription. (PIC freezes make it more difficult for consumers to switch carriers.) In Illinois and Michigan the PIC-freeze solicitations were found to be anticompetitive.[10] As discussed below, BOCs have also engaged in price squeezes in intraLATA toll markets.

23. There are also examples of non-BOC local telephone companies behaving anticompetitively in interLATA markets. For example, SNET has acquired a substantial share of the interLATA market in Connecticut despite having higher prices than competitors. This might be explained in part by premature termination of AT&T's billing contract with SNET.[11] In general, however, the incentives for discriminatory conduct are higher for BOCs than for independent telephone companies. Due to their geographic scope, a higher portion of interLATA traffic both originates and terminates within their territory.

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[9] See Florida Public Service Commission, Investigation into IntraLATA 1+ Presubscription, Docket Nos. 960658-TP and 930330-TP, December 23, 1996; Kentucky Public Service Commission, In the Matter of Implementation of IntraLATA 1+ Presubscription, Dockets 95-285 and 95-396, August 13, 1996.

[10] See MCI Telecommunications Corporation, et al, v. Illinois Bell Telephone Company, Illinois commerce Commission Case Nos. 96-0075, 96-0084 (Order dated April 3, 1996); and In the Matter of the Complaint of Sprint Communications Company L.P. Against Ameritech Michigan, Michigan Public Service Commission Case No. U-11038 (Opinion and Order dated August 1, 1996).

[11] See B. Douglas Bernheim and Robert D. Willig, *supra*, note 9, p. 92.

24. Dr. Taylor argues that experience in the cellar market provides evidence that the BOCs will not discriminate. The evidence Dr. Taylor cites for this proposition does not prove his point. For example, he points out that "despite a late start, non-wireline suppliers have market shares that are, on average, virtually equal to those of the Bell cellular companies." [para. 7] This is not at all surprising, given that cellular demand has been strong while each of the two competitors is constrained to half of the spectrum capacity.[12] Anticompetitive efforts to capture market share are unlikely to be profitable when capacity is constrained to begin with. Moreover, there were cellular interconnection disputes when the service commenced. Non-wireline carriers wanted to access local exchange networks on a carrier-to-carrier basis. The BOCs refused and offered instead to interconnect cellular carriers like any other large customer.[13] These disputes ended only after the BOCs came to dominate xxx the non-wireline side of the business through acquisitions.

25. The information service business does not provide a useful guide. Until passage of the 1996 Act, the BOCs were not allowed to provide interLATA information services. As a result, their opportunity to engage in anticompetitive behavior was limited to those few intraLATA information services that they provided, primarily voice messaging. Efforts to provide more sophisticated interconnection arrangements for ISPs failed in part because the BOCs resisted

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[12] With fixed spectrum, a cellular carrier would have to engage in expensive cell site splitting to capture a large fraction of its competitors traffic.

[13] Peter W. Huber, The Geodesic Network: 1987 Report on Competition in the Telephone industry (January 1987), pp. 4.12-4.15, describes early cellular interconnection disputes.

meaningful unbundling for information services and in part because access charges are priced substantially above cost.[14]

26. Dr. Taylor specifically mentions VMS as a case of successful BOC participation in information services markets. Yet one of the most well known examples of discrimination by a BOC is BellSouth's efforts to favor its own Memorycall service by strategically altering the timing of unbundled network features.[15]

27. It is significant that these examples of discrimination and delay all took place in the face of regulation by this Commission or state commissions. Even if a commission attempts to redress discrimination, it is only after the discrimination has already occurred and therefore after substantial competitive harm has already taken place.

28. The next example cited by Dr. Taylor is customer premises' equipment ("CPE"). CPE competition has flourished because the interface to the local network is simple and stable. Moreover, because the equipment manufacturing arm of the Bell System went with AT&T at divestiture and the BOCs were prevented from reentering manufacturing, opportunities and incentives for discrimination against equipment suppliers were reduced. Nevertheless, there have been competitive problems in the high end of the CPE business, where the BOCs' Centrex service

[14] For a discussion of the failure of Open Network Architecture to provide for meaningful interconnection arrangements for ISPs, see Hatfield Associates, "ONA: A Promise Not Realized" (April 6, 1995).

[15] See, In the Matter of the Commission's Investigation Into Southern Bell Telephone and Telegraph Company's of MemoryCall Service, Order of the Georgia Public Service Commission, Docket No. 4000-U, June 4, 1991.

competes. For example, Bell Atlantic delayed introduction of ISDN capability for PBX trunks for over a year after introducing the ISDN feature its own Centrex service.[16]

29. Dr. Taylor's appeal to the Commission's Computer III nonstructural safeguards does not help. [para. 19] As I pointed out above, the former interLATA information services restriction means that these safeguards have not been truly tested. Second, the existing accounting safeguards cited by Dr. Taylor apply to the division between regulated and non-regulated services. [para. 20] BOC provision of interLATA services will involve two regulated services provided over common facilities. Third, these accounting safeguards rely on inherently arbitrary allocations of joint and common costs. By selecting technologies with high common costs, the BOCs can artificially reduce the reported costs of competitive services.[17] Fourth, enforcement of accounting safeguards is resource-intensive. The enforcement costs of structural safeguards are much lower.

30. Price caps will not prevent discrimination. As long as the regulated firm remains subject to either an implicit or an explicit regulatory constraint, the incentive to cross-subsidize remains.[18] If the regulated firm is earning high profits and is subject to either profit sharing or performance reviews, then cutting prices of the services its affiliate uses will be profitable. Finally, to the extent price cap plans allow a monopolist to increase profits, its incentive to engage in technical discrimination that disadvantages rivals actually increases.

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[16] See B. Douglas Bernheim and Robert D. Willig, *supra,* note 9, Chapter 4, p. 97.

[17] *Id.* Chapter 4, pp. 69-70.

[18] See John W. Kwoka, Jr., "Statement on LEC Price Cap Reform" (January 1997), filed with Comments of MCI In the Matter of Access Charge Reform, CC Docket No. 96-262 (January 29, 1997).

31. Imputation is also a flawed mechanism for ensuring nondiscrimination. [See Taylor Affidavit, para. 21] Experience in administering the imputation rules for existing intraLATA toll rates shows that these rules are difficult to enforce in the face of incentives for the local monopoly telephone companies to abuse them. Moreover, even with imputation, payments from the long distance affiliate of the monopoly telephone company to the monopolist are simply a transfer. Thus imputation does little to counter the incentives to discriminate discussed above.

32. The problems with imputation are illustrated by experience in New York. At the request of AT&T and MCI, I reviewed imputation of access charges by New York Telephone ("NYT") for its toll and Regional Calling Plan ("RCP") services. I concluded that despite the New York Commission's imputation rules and policies, many NYT intraLATA toll services were priced too low to allow efficient interexchange carriers to make a profit. A proper imputation test requires imputation of both access and the incremental costs of the non-access components of the service. The NYT imputation analysis contains unrealistically low costs of administration and marketing. As a result of this, and other problems I identified, NYT has placed its competitors in a price squeeze. The result is that interexchange carriers have not aggressively marketed intraLATA toll services in New York.

VII. THE MANNER IN WHICH INTERLATA SERVICES ARE PROVIDED TO AFFILIATES DOES NOT AFFECT THE CONCLUSION THAT CONSUMERS WILL LIKELY BE HARMED

33. The incentive to discriminate is not affected by whether the interLATA service provided by the BOC is bundled or unbundled. Dr. Taylor argues that "whether the wholesale interLATA service is offered in isolation or as part of a 'bundled end-to-end' service that includes both interLATA transport and access, it must be made available to all carriers on the same terms as the